Nos. 11506, 11507.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

No. 11506.

VICTORIA L. COTTON,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

No. 11507.

VIRGINIA CALDWELL,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR REHEARING.

A. CALDER MACKAY,
ARTHUR MCGREGOR,
HOWARD W. REYNOLDS,
ADAM Y. BENNION,
728 Pacific Mutual Building, Los Angeles 14,
Counsel for Petitioners.

Parker & Company, Law Printers, Los Angeles. Phone TR. 5206.

TABLE OF AUTHORITIES CITED

Cases

Statutes

Textbooks

Nos. 11506, 11507.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

No. 11506.

VICTORIA L. COTTON,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

No. 11507.

VIRGINIA CALDWELL,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR REHEARING.

The petitioners, through their counsel, hereby petition the Court for a rehearing in the above-entitled causes.

1. As one ground for a rehearing it is respectfully submitted that the Court failed to pass upon one of the most important questions of law presented to it, and that is whether, in determining the value of income to be realized in the future, consideration must be given to future

income tax burdens. The Court in its opinion stated that it could not say from the record that the statement of The Tax Court, to the effect that it had considered future earnings and all speculative and other factors affecting the price of stocks, was untrue.

The record specifically shows that neither Grimes, Phillips nor Webb gave any consideration to the future burden of income taxes. Webb specifically stated that he had not given consideration to income taxes: "No, my opinion there was before taxes." [R. 452.] Grimes and Phillips stated that they had given consideration only to the 1940 rates [R. 600, 651], which is a definite admission that they did not take into consideration the prospects in existence for future taxes, of which there were many, as disclosed by the record. [See, for example, R. 657-660, particularly the report by Moody on May 5, 1941, "* * * It has been almost universally expected that the normal taxes of corporations would be increased from 24 per cent to 30 per cent * * *," *i. e.,* an increase of 25 per cent. Note that this was one month *prior* to our basic date.]

In view of these clear and unequivocal facts, the statement of The Tax Court that it gave consideration to these matters is not supported by the record but is directly contrary thereto.

What is the practical effect of failure to consider known expected increases in Federal income taxes? The answer, we believe, is obvious, but may be accentuated by the following figures: if a corporation had purchased the oil royalties of Dominguez for $2,700,000.00 and if the corporation subsequently realized the stipulated estimate of probable royalties in the amount of $9,000,000.00, its

income taxes, excess profits taxes and franchise taxes on such royalties *at the 1940 rates* would amount to $2,700,000.00, or roughly 30 per cent of the gross royalties; but the same taxes, *computed on the 1941 rates,* which, as we have seen, were universally expected on our basic date, would aggregate $3,500,000.00, or 39 per cent of the gross royalty. Thus, the net yield to the corporation on its investment would be reduced by more than one-fifth (from 14.4% to 11.3%) as a result of the foreseeable increase in taxes, a factor certainly to be considered in determining the amount to invest. Since the purchaser of such property would be interested primarily in the future yield, it is manifest that it would have in mind the taxes which would burden that yield, and expected increases in taxes would play an important part in determining how much it could afford to pay for the property. Since a purchaser always takes future taxes into account, we submit that The Tax Court erred in failing to do so.

Grimes had previously published a book in which he stated that the *future* tax burden must be taken into account in any valuation. [R. 655-6.] At an early date, 1926, the Bureau of Internal Revenue laid down the same rule for tax purposes, saying, "* * * That *future* Federal taxes will definitely affect such income and therefore the present earning value of the property cannot be questioned." (G. C. M. 45, C. B. V-1, 65.) The Supreme Court of the United States had approved this principle: "* * * all taxes which would be payable if a fair return were earned are appropriate deductions. There is no difference in this respect between state and Federal taxes, or between income taxes and others. * * *" (*Galveston Electric Co. v. Galveston,* 258 U. S. 388, 399, 42

S. Ct. 351, 66 L. Ed. 678. See, also, *State v. Oliver Iron Mining Co.,* 198 Minn. 385, 270 N. W. 609, 619.)

Hence, we submit, a rehearing of these cases is warranted to consider the effect of future income tax burdens upon The Tax Court's valuations.

2. Another ground for this petition is that the only testimony in support of a value of $900.00 per share for Dominguez stock is the testimony of Grimes, and Grimes refused to adopt "fair market value" as his criterion of value.

This Court states in its opinion that the weight to be given to Grimes' testimony "was a matter for The Tax Court, not this court, to determine;" and that when The Tax Court found a valuation for Dominguez stock higher than the values given by seven expert witnesses and lower only than the value given by Grimes, The Tax Court was merely resolving conflicts in the testimony and determining "the weight to be given to the testimony of each expert."

We respectfully submit that the correct rule of law is that the weight to be given the testimony of an expert witness is not a matter solely for determination by the trial court where it appears unmistakably that such witness used an erroneous standard of value and failed to apply the judicial meaning of "fair market value." We firmly believe it to be within the province of an appellate court—indeed, it is its duty—to say to the lower court, "There is no question about the weight to be given such testimony; it is error of law to consider it at all."

In *Powers v. Commissioner,* 312 U. S. 259, 260, 85 L. Ed. 817, the Supreme Court declared that:

> "the question of what criterion should be employed for determining the 'value' of the gifts is a question of law. See Lucas v. Alexander, 279 U. S. 573, 49 S. Ct. 426, 73 L. Ed. 851, 61 A. L. R. 906. Accordingly, the Circuit Court of Appeals was justified in reversing the decision of the Board as 'not in accordance with law'."

Grimes was frank in admitting he had failed to consider the factors required to be considered in determining fair market value. He merely valued the assets of the corporation, divided that figure by the number of shares outstanding, and called the resulting figure of $933.31 "fair market value." [R. 628, 681-2.] He refused to consider earnings, either past or prospective, and in fact he specifically stated that he could not consider earnings. [R. 629.] And he was equally clear that his value was not a public fair market value, for he admitted that no one other than a present stockholder would pay any such price for the stock. [R. 682-3.]

This Court, the Supreme Court, and practically every other court in the land have renounced Grimes' theory as a proper criterion of "fair market value." The cases are cited in petitioners' briefs in these cases heretofore filed. We respectfully urge that The Tax Court, in preferring the testimony of Grimes over the testimony of seven other witnesses, was not merely resolving conflicts in the testimony, but was adopting and relying upon an erroneous standard or criterion of value, and in so doing it committed an error of law which this Court has the power to correct, in line with the *Powers* case. It is plain from

the record that Grimes ignored earnings, future income taxes, other factors mentioned in Section 86.19 of Treasury Regulations 108, and in fact disregarded the very meaning of "fair market value." There being no testimony in the case, except Grimes', to support a value of $900.00 per share, and that evidence not taking into consideration the earnings and other factors, it is evident that The Tax Court itself could not possibly have given consideration to the factors mentioned in the Regulations.

3. A third ground for rehearing is that this Court, as The Tax Court, erroneously assumed that Eitner, one of petitioners' witnesses, attempted to establish a fair market value of the oil properties, whereas he stated emphatically that he was not doing so. [R. 378-9.] In any event, it was erroneous for The Tax Court to consider only one portion of his testimony and not all of it, as he did determine a value of Dominguez stock of $407.00. [R. 386.]

4. A fourth ground for rehearing is that the Court, we believe, erred in giving the same weight to the findings of fact made by a Judge who did not hear the evidence as it would to the findings of fact made by a Judge who did hear the evidence. This, we submit, is error. See *Howell Turpentine Co. v. Comm.,* 5 Cir., 162 F. (2d) 319, 325; *Howell v. Comm.,* 5 Cir., 162 F. (2d) 316, 317.

5. The Court in its opinion states with respect to the so-called sales of Francis and Dominguez stock:

> "* * * The parties to these sales were related to each other. Petitioners therefore contend that these sales should not have been considered by The Tax Court in determining the fair market value of Francis and Dominguez stock on June 5, 1941. * * *"

We believe, with all due respect, that the Court has misconceived the main point of petitioners' argument. We do not contend that mere relationship between the parties *ipso facto* renders the sales irrelevant. But we do believe it is well settled in all phases of tax law that transactions between members of the same family should be closely scrutinized—in this instance for the purpose of ascertaining whether the transfers constituted representative arm's-length sales or were merely transfers at arbitrary figures. The record in this case conclusively shows the latter.

Thus, a matter not commented upon by the Court is that the alleged sales of Francis and Dominguez stock on January 18, 1939, and April 24, 1941, were not cash sales, nor were they even sales in consideration of interest bearing deferred payments. They were transfers to children in exchange for non-interest bearing notes. And the fact that they represented merely arbitrary values is shown by the transfer by one of the petitioners of both Francis and Dominguez stock on the same day (January 18, 1939) at exactly the same price, although it is conceded on all sides that the Francis stock was worth 10 per cent more than the Dominguez stock. The price used was the income tax cost basis of both stocks, since no loss could have been claimed upon such a sale for tax purposes in any event. The alleged sales of both stocks in October, 1936, were also for the same price.

Petitioners respectfully urge that transfers under such circumstances are not representative sales nor are they indicative of fair market value. To permit The Tax Court to be the sole judge of the materiality, relevancy, and therefore the admissibility of this evidence is, we believe, contrary to the excellent opinions of this Court in *Kinney's Estate v. Comm.*, 80 F. (2d) 568, 572, and

of the Third Circuit Court of Appeals in *Hazeltine Corporation v. Comm.,* 89 F. (2d) 513, 519.

It is also submitted that no consideration appears to have been given to the fact that we are concerned here with a depleting asset. The parties stipulated the diminishing returns expected to be realized from the oil properties, amounting to $9,000,000.00 over a period of 25 years or more. Between 1936 and 1941 $5,000,000.00 had been received, thereby exhausting one-third of the oil reserves. Sales of stock in 1936 are irrelevant in determining value of the stock in 1941, after one-third of a depleting asset has been exhausted; and we believe that an appellate court should not hesitate to strike down a Tax Court finding predicated upon evidence that is irrelevant, immaterial or incompetent. This Court did not hesitate to do so in the cases cited on page 28 of petitioners' opening brief.

6. As a final ground in support of this petition, attention is respectfully directed to the action of Congress in requiring a comparison with other similar companies. Section 811(k) of the *Internal Revenue Code* was added by Section 501 of the Revenue Act of 1943 and reads as follows:

> "(k) Valuation of Unlisted Stock and Securities.—In the case of stock and securities of a corporation the value of which by reason of their not being listed on an exchange and by reason of the absence of sales thereof, cannot be determined with reference to bid and asked prices or with reference to sales prices, the value thereof shall be determined taking into consideration, in addition to all other factors, the value of

stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange."

There was undisputed evidence in the record that the stocks of comparable companies were selling on the public market at prices reflecting a substantial discount below fair market value of their underlying assets (from 20 to 40 per cent in the case of companies owning liquid assets and as high as 75 per cent as to companies owning real estate). [R. 250-1, 381-4, 550.] The record also shows conclusively that stocks of the best representative companies were selling at from seven to twelve times earnings. [R. 247, 341-2, 625-6.]

We submit that The Tax Court's valuation conclusively shows that it ignored this uncontradicted evidence and that it thereby disregarded the mandate of Congress. The earnings of Dominguez of $48.00 per share, multiplied by 12, produce a figure of only $576.00; and no discount from asset value was allowed by the Court at all.

In view of the foregoing we respectfully pray that this petition be granted.

A. Calder Mackay,
Arthur McGregor,
Howard W. Reynolds,
Adam Y. Bennion,
Counsel for Petitioners.

State of California, County of Los Angeles—ss.

A. Calder Mackay and Adam Y. Bennion hereby certify that in their judgment the foregoing petition is well founded and is not interposed for delay.

A. Calder Mackay.
Adam Y. Bennion.

Subscribed and sworn to before me this 5th day of March, 1948.

(Seal) Mary E. Whitthorne,
Notary Public in and for Said County and State.

My commission expires November 26, 1949.